Before the

Federal Communications Commission

Washington, D.C. 20554

In the Matter of	)	
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Review of the Commission's Rules Regarding the Pricing of Unbundled Network Elements and the Resale of Service by Incumbent Local Exchange Carriers	)	WC Docket No. 03-173
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REPLY COMMENTS OF AMERICATEL CORPORATION

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I. Introduction & Summary

Americatel Corporation ("Americatel"),[1] through counsel, respectfully submits its reply comments in response to the *NPRM* issued by the Federal Communications Commission ("FCC" or "Commission") in the above-captioned proceeding.[2] Americatel chiefly responds herein to the economic analysis proffered by BellSouth Corporation ("BellSouth") and Qwest Communications ("Qwest") in support of major changes to the Commission's pricing rules for Unbundled Network Elements ("UNEs") that are currently based on the Total Element Long Run Incremental Cost ("TELRIC") for the provision of a UNE.

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[1] Americatel, a Delaware corporation that is a subsidiary of ENTEL Chile, is a common carrier providing domestic and international telecommunications services. ENTEL Chile is the largest provider of long distance services in Chile and also provides wireless and competitive local services in the Chilean market. Americatel also operates as an Internet Service Provider ("ISP"). Americatel specializes in serving Hispanic communities throughout the United States, offering presubscribed (1+), dial-around, and prepaid long distance services, as well as private line and other high-speed services to its business customers. The majority of traffic carried by Americatel is dial-around in nature.

As stated in its initial comments in this proceeding, Americatel opposes any changes to the Commission's pricing rules for UNEs. The TELRIC rules that govern UNE pricing, which were affirmed by the United States Supreme Court, are working to bring competition to local markets. Therefore, Americatel submits that these rules must be protected from repeal.

Americatel explains that both BellSouth and Qwest, while mouthing support for the continued use of forward-looking costs for pricing UNEs, actually are seeking to price UNEs on embedded costs in order to drive up the price for UNEs and reduce local competition. The BOCs' position in support of the use of embedded costs for pricing flies in the face of long-standing BOC advocacy in favor of pricing all services without regard to their embedded costs. Americatel offers prior BOC testimony that strongly condemns the use of embedded costs for pricing and that urges prices be set based on forward-looking costs for a hypothetical network that may not yet exist. The BOCs' latest contention regarding costs for pricing should not be accepted without a valid explanation for their radical change in position.

Americatel demonstrates that BellSouth's argument in favor of the use of estimated depreciation costs based on a BOCs' projected plant retirements is inconsistent with BellSouth's contemporaneous advocacy of the use of embedded costs for pricing UNEs. The Commission must continue to base BOC depreciation expenses on the BOCs' actual retirement

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Continued from previous page

2 *Review of the Commission's Rules Regarding the Pricing of Unbundled Network Elements and the Resale of Service by Incumbent Local Exchange Carriers*, Notice of Proposed Rulemaking, WC Docket No. 03-173, FCC 03-224 (rel. Sept. 15, 2003) ("*NPRM*").

history for their network plant investments. The BOCs have an incentive to overstate their planned investments and are not likely to engage in the wholesale replacement of their copper-based local distribution networks because their existing networks were engineered based on a "bandwidth shortage" concept that, in turn, permits the BOCs to exploit those bandwidth shortages to generate higher revenues than if customers had access to virtually unlimited bandwidth over a entirely fiber optic cable-based local distribution network. Accordingly, the BOCs are not likely to deploy entirely fiber optic cable-based local distribution networks on any wide-scale basis or in the near term.

The Commission does not have an obligation to guarantee that the BOCs can recover all of their capital investments when those investments are not recoverable in the marketplace so long as the BOCs are permitted to earn a fair rate of return. The existing price cap regulation system permits the BOCs to earn profits that exceed a fair rate of return. Indeed, evidence before the Commission demonstrates that the BOCs have generally earned profits that are higher than a fair rate and, therefore, have already been compensated for any risk that they might not be able to recover all of their investments due to competition.

Verizon's recent proposal to seek legislation in Virginia that would permit it to raise local rates by 10% per year demonstrates that the BOCs' argument that the local exchange market is competitive is totally fallacious. It was not the intent of Congress or the President that local competition would actually result in higher prices for local service. The fact that local service prices are higher today than in 1996 shows that the local exchange market is not competitive despite the BOCs' rhetoric to the contrary. Under these circumstances, the FCC must not alter its TELRIC rules in any manner that would increase the price of UNEs and decrease local competition.

II. TELRIC Rules Should not be Based on Embedded Costs

A. BellSouth's Position on TELRIC

BellSouth supports the "retention of a forward-looking cost methodology" for determining TELRIC costs.[3] (Americatel agrees with BellSouth's general statement.) However, BellSouth then sets forth more detailed principles for the reformation of the TELRIC rules in its Exhibit 1. In those details, BellSouth, while still professing to support the use of "a forward-looking cost methodology" for TELRIC, attempts to include other "costs" in the cost study formula that are simply not forward-looking in nature. Moreover, as discussed below, BellSouth's position on forward-looking costs is contrary to the economic testimony proffered by the Bell Operating Companies ("BOCs") when they were attempting to restructure and reprice private line services in the advent of competition.

BellSouth recommends that the Commission utilize a BOC's "actual results where this information provides good evidence about forward-looking relationships or costs."[4] BellSouth would also like the FCC to accept all other costs that a BOC would incur "as a carrier of last resort," including, but not limited to, "the cost of capital and related cost of capital structure;" costs related to the BOC's "existing network equipment locations, routes, and network parameters;" and stranded investments for network connections to customer locations that are no longer served by the BOC.[5] In other words, BellSouth wants the FCC to permit the BOCs to price UNEs based on embedded costs. However, in a seemingly contrary position to its

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[3] Comments of BellSouth, at 2.

[4] *Id.*, at Exhibit 1, first unnumbered page.

[5] *Id.*, at first and second unnumbered pages.

focus on the use of historic costs for pricing UNEs, BellSouth believes that the depreciation component of TELRIC should be based on "forward-looking economic life estimates, … used by the [BOC]."[6] Another key component for TELRIC proposed by BellSouth is "[t]he cost of the loop should not be allocated to various services carried over it, … [but] should be assigned to the customer causing the cost regardless of which services the customer orders."[7]

B. Qwest's Position on TELRIC

Qwest's economic views on the proper components for a TELRIC study are set forth in a paper by Professor Dennis L. Weisman from Kansas State University.[8] Professor Weisman recommends that "TELRIC should not distort the 'build or buy' decision of rivals in determining their respective [market] entry strategies."[9] He too supports the use of a "long-run, forward-looking cost standard" for TELRIC, but also wants this standard to "reflect[] the actual characteristics of the ("presumptively efficient") incumbent provider."[10] According to Qwest's expert, a BOC's forward-looking costs must be objectively based on its actual costs, rather than based on unverifiable speculation about hypothetical networks.[11] Professor Weisman seemingly

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[6] *Id*., at first unnumbered page.

[7] *Id*., at second unnumbered page.

[8] Dennis L. Weisman, "The Theoretical Economic Principles Underlying TELRIC," December 16, 2003, ("*Weisman*"), filed as a part of Qwest's Comments in this proceeding.

[9] *Id.*, at 7.

[10] *Id.*, at 9. Professor Weisman would also require his forward-looking cost study to "comport with the facts on the ground." *Id.*, at 14. This condition seems to require some consideration of the BOC's embedded network and associated costs. Further, Professor Weisman would have the Commission presume that price cap regulation has rendered the BOCs efficient in their provision of service. *Id*., at 18-20.

[11] *Id.*, at 22-23.

assures the Commission that the BOCs have no incentive to overstate costs for their rivals and worries that the use of a "hypothetical TELRIC" would result in a "paradox in which the [BOC] can be underpriced (foreclosed) by a less efficient rival using the [BOC's] own network.[12] Finally, Qwest's expert recommends that the prices for service include "the actual resource costs borne in producing that good or service."[13]

C. What BellSouth and Qwest Really Want

Essentially, when all of the smoke is cleared, BellSouth and Qwest (and probably the other BOCs as well) really want the FCC to set UNE prices at rates that recover all of the carriers' embedded costs. The BOCs do not want to price UNEs based on any forward-looking costs, except for forward-looking depreciation costs based on fanciful projections of massive plant retirements that are not likely to occur. Indeed, BellSouth has always supported rules that would permit it to recover its embedded costs in UNE rates. BellSouth argued in its May 16, 1996 Comments to the FCC in the Local Competition rulemaking proceeding:

> It is appropriate that embedded costs be included in the measure of total costs that incumbent LECs be permitted to recover in charges for interconnection and unbundled elements (subject to the upper bound measures discussed above [*i.e.,* market price, access charges or stand-alone costs]). These costs were properly incurred pursuant to regulatory oversight and regulators must permit them to be recouped. [14]

Likewise, Qwest, then US West, argued to the FCC in 1996 that the Constitution required the FCC to permit the BOCs to set rates for "interconnection and unbundling that permit

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[12] *Id*., at 23.

[13] *Id.,* at 25.

[14] Comments of BellSouth in CC Docket No. 96-98, at 57 (May 16, 1996).

incumbent LECs to recover their full costs of providing interconnection and unbundled network elements as well as a reasonable profit." Anything short of that would, Qwest argued, "render the 1996 Act unconstitutional."[15] In short, the BOCs wanted (and still want) simultaneously to be treated as fully regulated companies that are entitled to a guaranteed recovery of all expenses, including depreciation,[16] and a profit on their investments (a "cost-of-service" regulatory framework) and as unregulated businesses without any regulatory restrictions on their prices or service obligations.

Needless to say, the law does not grant the BOCs their heart-felt desire to have their cake and eat it too. The Supreme Court upheld the existing TELRIC rules in the case of *Verizon Communications, Inc, v. FCC*.[17] In *Verizon*, the BOCs argued that the term "cost" in Section 252(d)(1) of the Communications Act of 1934, as amended ("Act")[18] (relating to UNEs) referred "to 'historical' cost, which [the BOCs] define[d] as 'what was in fact paid' for a capital asset … ."[19] Moreover, the BOCs contended that the "technical meaning of 'cost' [was] 'past capital expenditure'"[20] and suggested "an equation between 'historical' and 'embedded' costs, which the FCC defines as 'the costs that the incumbent LEC [*i.e.,* the BOCs] incurred in the past

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15 Comments of US West in CC Docket No. 96-98, at 27-28 (May 16, 1996).

16 It must be noted, however, that even fully regulated utilities are not necessarily entitled to a recovery of all past capital expenditures, even when prudently made, when unexpected events render those investments useless. *See Duquesne Light Co. v. Barasch*, 488 U.S. 299, 312 (1989).

17 *Verizon Communications, Inc. v. FCC,* 535 U.S. 467 (2002).

18 47 U.S.C. §252(d)(1).

19 *Verizon*, 535 U.S. at 498, *citing* the BOCs' Brief at 19.

20 *Id.*

and that are recorded in the incumbent LEC's books of accounts."[21] The Supreme Court, however, simply rejected the BOCs' arguments holding that the cost study methodology chosen by the FCC was not inconsistent with the plain language of the Act and was not unreasonable. The highest court in the land has found the current TELRIC rules reasonable.

In light of this background, the Commission must conclude that the BOCs are merely paying lip service to the use of forward-looking costs for pricing UNEs. The BOCs want the Commission to permit them to price UNEs based on embedded costs in order to raise the price of UNEs to their competitors. The Commission must not grant the BOCs' wish to modify the TELRIC formula in order to produce higher UNE rates and less local competition.

III. The BOCs Are Singing a Different Song on Costs for Pricing

A. Restructured Private Line Costs

In the late 1970s, the Bell System (*i.e.,* the BOCs) began a nationwide effort to restructure and reprice private line services and filed a number of tariff revisions that were based on forward-looking costs of providing service. One such filing occurred in the state of Iowa.[22] Northwestern Bell Telephone Company ("NWB"), which is now an integral part of Qwest, filed tariff revisions with the Iowa Commerce Commission ("ICC") (now the Iowa Utilities Board ("IUB")) to revise NWB's intrastate private line rates. The tariff revisions were suspended by

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21 *Verizon*, at 498 (internal references omitted), *citing* the BOCs' Brief at 19-20 and 47 C.F.R. §51.505(d)(1).

22 *In the Matter of Northwestern Bell Tel. Co.*, Docket No. RPU-79-35 (Iowa Commerce Commission 1979) ("*RPU-79-35*"). The BOCs were directed by AT&T's General Departments to restructure and reprice their private line services based on Bell System Guidelines set forth in GL 77-10-125. *RPU 79-35*, Hearing Transcript, at 29-30 ("*Iowa TR*").

the ICC and set for investigation. NWB and other parties pre-filed direct testimony, which was then tested on cross examination during three days of hearings held before the ICC.

NWB conducted cost-for-pricing studies for its private line services. According to NWB's cost study witness, "[t]he purpose of a cost for pricing study is to identify all the directly identifiable costs the Company [NWB] will incur in providing any given service offering" and were "conducted on a forward-looking basis using a three-year planning period with the costs based on 1980 levels."[23] NWB testified that the costs for intrastate private line services were "developed using cost factors and methods consistent with sound economic principles."[24]

When asked to provide more detail on the BOC's costs, the witness testified as follows:

> The unit incremental costs for private line service measure the change in direct costs (or savings of costs) resulting from the provision of additional (or fewer) units of that service. The costs are at a 1980 level for the type of equipment we [NWB] anticipate purchasing to provide private line service during the next three to five years.[25]

On cross-examination, NWB's witness confirmed that the Company was seeking to recover "costs which may be incurred in the future," rather than "costs actually being incurred historically or presently."[26] The same witness was also asked whether he and his subordinates

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[23] *Id.*, at 11-12.

[24] *Id.*, at 12.

[25] *Id*. In compliance with the ICC's cost study policies, NWB added a factor to the incremental costs to contribute to the Company's common overheads. *Id.*

[26] *Id.*, at 40.

saw "any problems in [NWB] recovering on an investment that may not even exist at the time the rates went into effect."[27] After some further clarification of this question, the BOC's witness answered as follows: "That does not bother me at all, because I think that's the proper cost. In fact, it's the state-of-the-art cost that may well be less."[28]

Further examples from the cross-examination of the BOC's cost witness in 1980 should also be instructive to the Commission in evaluating the BOCs' latest attempt to price UNEs based on embedded costs. One of the opposing counsel pressed the NWB witness about his decision to calculate the costs for providing services based on equipment that might be purchased by the BOC, instead of equipment actually being used to provide private line services in Iowa. In response, the witness agreed with the characterization that his investment costs were not based on planned equipment purchases, but rather on examples of the type of equipment that would likely be purchased over the next three-to-five years.[29] The witness affirmed his belief that he had used the economically correct cost for pricing. In other words, the BOC argued that costs for service should be based on the "forward-looking, the more modern technology" that would likely be used in the future.[30] The witness gave an example of the type of modern equipment that his organization used to calculate costs. NWB assumed that costs should be calculated based on the use of T-1C equipment that NWB might purchase sometime in the future

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[27] *Id.*, at 109.

[28] *Id.*

[29] *Id.*, at 128-29.

[30] *Id.*, at 129.

even though that equipment was not widely deployed by NWB in its actual network.[31] Essentially, the BOC argued that it must be permitted to price its services based on the forward-looking costs of a hypothetical state-of-the-art network – a position that certainly seems to contradict the BOCs' present position on TELRIC.

NWB also provided the testimony of a economist, Dr. Dennis Johnson, who was, at that time, a professor of economics at the University of South Dakota and a visiting professor of economics at the University of Iowa. Dr. Johnson testified that the proper costs for pricing telecommunications services were forward-looking marginal costs.[32] His testimony included supporting references from textbooks by Nobel Laureate Paul Samuelson and by Alfred Kahn, one of the leading economists in the telecommunications area.[33]

Dr. Johnson's testimony addressed criticisms of the use of marginal costs for pricing services:

> Second, to raise eyebrows at the assumptions necessary to make it logically certain that MC [Marginal Cost] pricing will maximize social well being, and to indicate difficulties in the use of marginal cost concepts, is not the same thing as to advocate embedded or any other cost as the appropriate cost upon which to base prices.

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31 T-1C or Trunk Level 1 Combined Equipment has a total signaling rate of 3.152 Mbps in North America and "comprises two T-1s, which are interleaved to support 48 DS-0s at 1.544 Mbps each. The additional 64 Kbps is overhead used to support additional signaling and control requirements. T-1C is seldom used, outside of [sic] limited telco applications." Harry Newton, NEWTON'S TELECOM DICTIONARY 801 (15th Edition).

32 *Iowa Tr.,* at 6.

33 *Id.*, at 6-7, quoting Paul Samuelson, ECONOMICS (10TH Ed.), at 498 and Alfred Kahn, THE ECONOMICS OF REGULATION, Vol. I, at 66-67 ("*Kahn*"). Interestingly, the BOC's quotations included Dr. Kahn's statement: "If buyers are charged more than the marginal cost for a particular commodity, for example[,] because the seller has monopoly power, they will buy less than the optimum quantity." *Kahn, id*. Today, the BOCs would likely define the optimum quantity of UNEs (from their perspective) to be zero.

> To establish embedded (or other) costs as appropriate costs upon which to base prices it must be shown that any such costs are not subject to the same and worse criticisms than is current marginal cost.[34]

According to Dr. Johnson, "[e]conomists generally believe that resources should be allocated in such a way that the most valuable products should be produced."[35] (Presumably, this economic principle would also govern a competing carrier's decision to purchase UNEs from a BOC or to invest in the CLEC's own network facilities.)

Dr. Johnson was also asked to explain why costs for pricing must be forward-looking. He responded as follows: "A pricing decision is by its very nature a decision for the future. We are trying to decide now [in 1980] what the price should be in, for example, 1981, and whether our decision is a good one or a poor one depends on what happens in 1981."[36] Similarly, Dr. Johnson testified as to why prices should not be based on embedded costs. "Embedded direct costs are historical, and hence are irrelevant for setting prices in future time periods."[37] Similarly, the BOC's witness testified that it was illogical to support the use of embedded costs for pricing simply because those costs may be known, while marginal costs must be estimated.[38] Dr. Johnson also dismissed any relationship between a carrier's prices, which should be based on forward-looking marginal costs, and its regulated rate base.[39]

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[34] *Iowa Tr.*, at 355.

[35] *Id*., at 357.

[36] *Id.*, at 358.

[37] *Id.*, at 361.

[38] *Id*., at 362.

[39] *Id.,* at 362-63.

Given the nature of the Bell System, it is very likely that a diligent search of dusty PUC file rooms and off-site warehouses where government records are stored around the country would produce similar testimony over the years by other BOC experts with respect to the appropriateness of forward-looking costs for telephone service pricing. NWB's position on the appropriate costs for pricing was not an aberration. Rather, back in the 1980s, the BOCs fought hard and relentlessly to persuade regulatory bodies all over the United States that telephone service prices should be set with reference to forward-looking marginal costs instead of embedded or historical costs. By and large, the BOCs won that battle. Both the FCC and state PUCs generally allow rates for regulated services to be based on—or at least, related to—forward-looking costs. Now, it seems that the BOCs want to abandon their hard-fought victory and return to the use of embedded costs.

B. Why the Change in Position?

In and of itself, it is not unreasonable for one or more of the BOCs to change position on an issue – especially when the original position was taken more than 20 years ago. However, moving from a position that costs for pricing must be forward-looking in nature to a position that costs for pricing must be embedded in nature is a change of tsunamic proportions for the BOCs. This radical change in position cannot be accepted by the FCC without explanation from the BOCs. The Commission should not simply permit the BOCs to pretend that their past position that prices must be based on forward-looking costs did not exist because they have found another approach that will better protect their market share. Regulators, consumers and competitors all deserve a better answer from the BOCs about their blatant inconsistency than the "Never Mind" that would have likely been supplied by *Saturday Night Live's* immortal Gilda Radner (as "Emily Littela") had she been asked to explain the BOCs' massive shift in economic pricing theory.

The plain and simple truth about the BOCs' current position on the use of embedded costs for UNE prices is that it is impeached by years of their own contrary arguments in favor of forward-looking costs as the only fair costs for pricing telephone services. The BOCs' current position is patently self-serving and designed only to protect their retail market shares by increasing their competitors' costs for UNEs. The FCC should simply ignore the BOCs' Johnny Come Lately arguments in this area.

IV. Depreciation Expenses

A. BellSouth's Position on Depreciation Expenses Is Inconsistent with Its Advocacy of the Use of Embedded Costs

At the same time as BellSouth supports the use of embedded costs for pricing UNEs, BellSouth argues that: "Depreciation expense in the [TELRIC] cost study should be based on forward-looking economic life estimates."[40] BellSouth argues that technology is driving carriers to upgrade their networks on a much faster basis, which, in turn, shortens the economic lives of their existing equipment.[41] Further, BellSouth discounts carriers' actual retirement experience because "retirement experience is like looking in a rear view mirror …, [it] provides a view of where you have been but provides absolutely no information as to what lies ahead."[42]

This argument is logically at odds, but strategically consistent, with the general BOC position that UNE prices should reflect historical costs since the goal of the BOCs is to cobble together each and every regulatory principle or economic theory that pushes UNE prices

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[40] Comments of BellSouth, Exhibit 1, first unnumbered page.

[41] Comments of BellSouth, at 33 *et seq*.

[42] *Id.*, at 37.

upward, making local competition more difficult. The Commission should view this argument for what it is—another charade to stall competition—and then the Commission should reject it. Further, it is incredible for the BOCs to argue that the TELRIC rules have reduced their incentive to invest in new plant, while, at the very same time, they also argue that they plan to increase their network investments substantially, which, in turn, necessitates shorter lives for plant and higher depreciation rates to be built into UNE prices.

Moreover, a BOC's history of plant retirements is relevant to its estimates of forward-looking depreciation costs that should be included in UNE rates. A BOC has a strong incentive to overestimate its future depreciation costs for inclusion in UNE rates since the greater the depreciation expense, the higher the price for UNEs and the less competitive the market.

Since a BOC has an economic incentive to overestimate its projected depreciation expenses by predicting short economic lives for its plant accounts, the Commission should check what a BOC says against what it has actually done in terms of plant retirements. The BOCs, just as with most other for-profit entities, often adopt major capital investment plans only to cut them back as markets or earnings soften. This trend will most likely continue into the future as the economy naturally waxes and wanes.

Also, the BOCs have a history of hanging on to obsolete facilities so long as they can still eke out revenues from customers. For example, BellSouth, NYNEX, Pacific Telesis and US West each had crossbar equipment in operation as late as December 31, 1996, despite the fact that crossbar-switching technology became obsolete many years earlier with the availability of

analog and digital electronic switches.[43] The Commission should, therefore, temper the BOCs' optimistic predictions for capital spending and equipment retirement plans with the BOCs' actual experience in order to protect the overstating of the BOCs' depreciation costs.

Much of the BOCs' UNE investments are in copper wires and cables that serve individual business and residential customers. BellSouth, for example, predicts an "avalanche of retirements" because of competition and technological changes.[44] Presumably that prediction includes massive retirements of copper wires and cables connecting end user customers to BellSouth's switches. Those major retirements are not likely to occur.

While the BOCs may well replace some copper cables with fiber optic cables in their distribution plant,[45] it is still very unlikely that they will engage in any large-scale deployment of fiber to the home (or small business). There have been instances of the BOCs' deployment of fiber-to-the-home ("FTTH"), but those deployments are still quite rare.[46] Indeed,

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[43] FCC, STATISTICS OF COMMUNICATIONS COMMON CARRIERS, 1996-97 Ed., at Table 2.9. *See also, US West Communications, Petition for Authority to Continue to Charge Premium Rates for Access Service after 1992*, Order, 8 FCC Rcd 190 (1992) (granting US West's waiver request to continue to charge long distance carriers premium access charge rates for services provided from step-by-step and other electromechanical offices beyond the FCC's December 31, 1992 "drop-dead" date for replacing those switches or charging non-premium rates from such offices).

[44] *Id.*, at 38.

[45] Because the BOCs have found some fair success in selling DSL services to both residential and small business customers and because DSL services must ride an entire copper-based facility, the deployment of any fiber cables into their distribution networks creates problems for their continued successful marketing of DSL services. Hence, the Commission must be wary of the BOCs' argument that they will soon engage in the wide-scale deployment of fiber in their distribution plant ("fiber-to-the-neighborhood").

[46] *See, e.g.,* Verizon Communications, *Video Access Transport Service, Fiber To The Home Digital Data Service,* Short Term Public Notice of Network Change Under Rule 51.333(a) (Oct. 6, 2001) *available at* http://www22.verizon.com/regulatory/files/pubno_ftth.pdf (visited January 7, 2004) (announcing the availability of "Video Access Transport Service" with transport rates of "either a 55 MHz - 370 MHz (Verizon Spectrum 1) or a 950 MHz – 2050 MHz (Verizon Spectrum 2)

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many within the telecommunications industry believe that these FTTH deployments will be the exception, rather than the rule.

B. "Isenberg's Paradox"

One expert who believes that the BOCs will not widely deploy broadband network facilities is Dr. David Isenberg. Dr. Isenberg, a former Distinguished Member of Technical Staff at AT&T Bell Laboratories ("Bell Labs") is a telecommunications consultant. He holds a Ph.D. in Biology from Cal Tech.[47] In 1997, while still employed at Bell Labs, Dr. Isenberg wrote an article, "Rise of the Stupid Network" that was published in *Computer Telephony*.[48]

Dr. Isenberg identified four principles underlying the telephone industry's design of the PSTN and the pricing of network services. These principles or assumptions are: (1) "that expensive, scarce infrastructure can be shared to offer premium priced services," (2) "that talk – the human voice – generates most of the traffic," (3) "that circuit-switched calls are the 'communications technologies' that matter," and (4) "that the telephone company is in control of its network."[49] The BOCs' response has been to create "Intelligent Networks," which permit

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> video signal over a single mode fiber optic cable from a video service provider to the customer's home" and "Fiber To The Home Digital Data Service is designed to provide high-speed data: 1.5 Mbps bi-directional or unrestricted (as an enhancement to the data service) to each home." Verizon has made this deployment at a new real estate development, Brambleton, in Loudon County, Virginia, an outer-ring suburban area of Washington, D.C.).

47 *See generally*, http://www.isen.com/Bio-Res/LongBio.html (visited January 7, 2004).

48 David Isenberg, "Rise of the Stupid Network," *Computer Telephony*, August 1997, at 16-26. ("*Stupid Network*"), *also available at* http://www.rageboy.com/stupidnet.html (visited January 7, 2004).

49 *Id*.

carriers to develop new and modified customer services without the need for carriers to purchase new switch software generics.[50] Intelligent technology, however, tends to keep control over the service creation function in the hands of the BOCs, rather than shift control to the customers, as would occur in a "Stupid Network."

Isenberg's article goes on to note that these assumptions continue to drive the incumbent carriers despite "several thousand-fold declines in key infrastructure costs," massive increases in the volume of data traffic, the emergence of many non-telephone network-based "'communications technologies' from television to Ethernet," and the development of the Internet.[51] According to Isenberg, all of these trends (which have actually accelerated since *Stupid Networks* was written in 1997) should have led incumbent carriers to abandon Intelligent Networks and their inherent scarcity element for "Stupid Networks" that are "nothing but dumb transport in the middle, and intelligent user-controlled endpoints" and whose design are "guided by plenty, not scarcity."[52] But that has simply not been the case.

The BOCs' entire business strategy is dependent on the maintenance of the scarcity principle in their networks. If the BOCs were to replace their existing distribution networks with facilities that could deliver virtually unlimited bandwidth to their residential and small business customers, the BOCs would effectively create "Stupid Networks" that would permit the BOCs' customers to engage in unlimited communication without any

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50 *See generally, Intelligent Networks*, Notice of Inquiry, 6 FCC Rcd 7256 (1991), Notice of Proposed Rulemaking, 8 FCC Rcd 6813 (1993).

51 *Stupid Networks, id.*

52 *Id.*

additional payments to the BOCs. There would be no need, for example, for customers to pay per-minute rates for long distance calls or added charges for features such as Call Forwarding or Caller ID. With access to bandwidth on a "plenty" basis, rather than on a "scarcity" basis, consumers would be able to talk with friends and relatives the same unconstrained way they engage in email or instant messaging communications.

Likewise, software vendors, such as Novell or Microsoft, would likely be more than willing to write software code that would permit a consumer to customize his or her own Call Forwarding or Caller ID services without any need for participation from the local BOC. The deployment of Stupid Networks with intelligent terminal equipment effectively turns the BOCs into water companies. If history is any guide, the BOCs will not allow this to occur without first engaging in a regulatory war of the highest magnitude.

As the Commission and the Industry well understand, foolish people do not manage the BOCs. By and large, the BOCs have attracted smart and resourceful employees, not just at the top executive levels, but also throughout their management and technical ranks. These people will not take actions that would jeopardize their financial viability. Therefore, the BOCs are not likely to deploy network facilities that would enable consumers simply to avoid paying the BOCs any revenues in excess of basic transport. The BOCs understandably want to capture value (higher revenues from consumers) for any new investments that they make.

In sum, the BOCs are unlikely to replace their existing copper-rich distribution networks with FTTH because it would enable consumers to control their own communications and associated costs. So long as consumers are dependent on the BOCs for the last mile link to the PSTN, both the FCC and state public utility commissions ("PUCs") can feel confident about maintaining long useful lives for network plant and low depreciation rates for the BOCs.

C. The BOCs' High Profit Levels Have Already Compensated Them for the Risks of Capital Non-Recovery

Inherent in the BOCs' arguments in favor of higher deprecation rates is the assumption that regulatory law and the Constitution each envision that the BOCs must recover each and every dollar of their capital investment. As noted earlier, the *Duquesne Light Co.* case holds that, so long as a utility's overall rate of return (*i.e.*, profit level) is reasonable, the Constitution does not require regulators to adopt the "prudent investment" rule, whereby the utility must be compensated for all of its prudent investments once made, irrespective of whether individual investments are deemed necessary or useful in hindsight.[53] In other words, there may well be circumstances when the BOCs need not be permitted to recover all of their plant investments that are no longer used and useful in the provision of telephone service. The BOCs simply need to be permitted to earn a fair profit on an overall basis.

Because of the existence of price cap regulation that does not limit their profit levels to a fair rate of return, the BOCs have not only been able to earn the Commission-prescribed fair rate of return, but they have also, in most instances, been able to earn at levels well above the prescribed fair rate of return. As the FCC recently explained:

> Although the initial price cap rates were set equal to the rates the LECs were charging under rate-of-return regulation, the rates of price cap LECs have been limited ever since by price indices that have been adjusted annually pursuant to formulas set forth in the Commission's Part 61 rules. Price cap carriers may earn returns

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[53] *Duquesne Light Co.,* 488 U.S. at 309.

> higher or lower than the prescribed rate of return that incumbent LECs are allowed to earn under rate-of-return regulation.[54]

As demonstrated below, the BOCs' profit levels have been well above what the FCC deems to be a fair rate of return. Accordingly, those super-profits earned by the BOCs have more than compensated them for the risk that they may not be able to recover all of their previous capital investments because of competition.

As former FCC Commissioner and now SBC Senior Vice President Patricia Diaz Dennis wrote in her separate statement approving price cap regulation: "Under traditional utility law, the return to shareholders of a regulated enterprise should be commensurate with returns on investments in other enterprises having corresponding risks."[55] The Commission has prescribed the maximum fair rate of return on investment for LECs to be 11.25%.[56] The BOCs' earnings have significantly exceeded the 11.25% ceiling on a regular basis. The following chart created by the FCC sets forth the BOCs' interstate earnings for 1997 through 2002.[57]

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54 *Access Charge Reform, Price Cap Performance Review for LECs, Low-Volume Long Distance Users*, and *Federal-State Joint Board on Universal Service*, Order on Remand, 18 FCC Rcd 14976, at ¶4 (2003).

55 *Policy and Rules Concerning Rates for Dominant Carriers*, Separate Statement of Commissioner Patricia Diaz Dennis, 4 FCC Rcd 6814 (1989), *citing FPC v. Hope Natural Gas Co*., 320 U.S. 591 (1944).

56 *Represcribing the Authorized Rate of Return for Interstate Services of Local Exchange Carriers*, Order, 5 FCC Rcd 7507 (1990), *recon.,* 6 FCC Rcd 7193 (1991), *aff'd Illinois Bell Tel. Co. v. FCC*, 988 F2d 1254 (D.C. Cir. 1993).

57 FCC, *Interstate Rate of Return Summary – Years 1997 through 2002* (May 2003) (internal footnotes omitted).

Interstate Rate of Return Summary *

Years 1997 through 2002

Price-Cap Companies Reporting FCC Form 492A

(Final Reports for 1997 Through 2001 and Initial Report for 2002) [1]

Prepared by Katie Rangos, Industry Analysis Division, April 15, 2003.

	Reporting Entity	2002	2001	2000	1999	1998	1997
1	**BellSouth Telecommunications, Inc.**	19.27 %	21.25 %	22.83 %	20.99 %	20.80 %	17.91 %
2	**Qwest Corporation, Including Malheur and El Paso**	NA	22.13	19.93	19.06	16.56	15.41
	SBC Communications, Inc.						
3	Southwestern Bell Telephone Company L.P.	15.51	18.81	15.17	10.22	9.91	10.32
4	Ameritech Operating Companies	20.91	25.72	30.24	28.93	22.59	18.22
5	Nevada Bell Telephone Company	15.97	20.86	21.55	19.26	16.02	19.47
6	Pacific Bell Telephone Company	21.76	23.79	19.20	21.01	16.50	11.98
7	Southern New England Telephone Company, The	19.64	23.57	18.21	12.12	10.99	12.70
	Verizon Telephone Companies						
8	Verizon Telephone Companies (Verizon FCC Tariff No. 1)	11.97	12.93	13.36	13.66		
	(Former Bell Atlantic Companies)						
	Bell Atlantic					13.88	14.73
	Bell Atlantic (NYNEX)					11.40	13.72
	New England Telephone and Telegraph Co.						
	New York Telephone						
	Verizon - West (Former GTE Companies)						
9	Verizon California Inc. (California - GTCA)	28.84	28.48	25.87	22.01	17.19	17.68
10	Verizon California Inc. (California - COCA)	28.24	29.80	28.74	28.28	22.71	19.16
11	Verizon California Inc. (Arizona - COAZ)	6.41	13.25	10.90	15.57	13.80	14.17
12	Verizon California Inc. (Nevada - CONV)	24.07	26.66	28.82	20.57	24.01	31.44
13	Verizon Florida Inc. (Florida - GTFL)	22.02	29.23	21.90	18.93	14.58	19.14
14	Verizon Hawaii Inc. (Hawaii - GTHI)	15.28	16.72	17.87	17.62	15.64	10.55
15	Verizon North Inc. (COPA + COQS = COPT)	39.35	39.71	41.05	39.58	45.97	36.83
16	Verizon North Inc. (Illinois - COIL)	54.01	53.67	44.51	41.03	14.11	41.14
17	Verizon North Inc. (Indiana - COIN)	46.00	46.55	47.67	41.40	34.61	33.26
18	Verizon North Inc. (Ohio - GTOH)	19.59	20.45	21.88	21.70	21.83	24.37
19	Verizon North Inc. (Pennsylvania - GTPA)	22.56	23.17	21.95	21.41	14.67	20.62
20	Verizon North Inc. (Wisconsin - GTWI)	9.81	14.16	16.99	17.85	16.08	18.75
21	Verizon North/Contel Systems of South (GTIN + GLIN = GAIN)	25.10	32.82	33.00	32.47	29.06	23.61
22	Verizon North/Contel Systems of South (GTMI + GLMI = GAMI)	16.65	17.49	16.45	15.75	13.17	15.33
23	Verizon North/GTE South (GTIL + GLIL = GAIL)	21.60	23.67	23.90	22.35	23.07	21.59
24	Verizon Northwest Inc. (Oregon - GTOR)	26.13	31.69	30.95	31.56	27.03	28.23
25	Verizon Northwest Inc. (West Coast CA - GNCA)	(5.18)	1.91	(8.35)	(9.93)	(6.85)	(25.83)
26	Verizon Northwest Inc. (Washington - COWA)	31.49	40.06	39.49	39.17	30.41	31.85
27	Verizon Northwest Inc. (Washington - GTWA)	29.00	34.03	33.26	32.91	27.33	24.41
28	Verizon Northwest Inc. (Idaho - GTID)	33.02	38.74	34.17	32.24	30.89	30.52
29	Verizon South Inc. (North Carolina - GTNC)	23.63	30.08	26.44	24.85	27.92	24.48
30	Verizon South Inc. (N. Carolina - CONC)	21.15	22.17	17.75	19.87	12.78	16.63
31	Verizon South Inc. (GTSC + COSC = GTST)	29.71	32.44	31.19	30.70		
	Verizon South Inc. (Alabama - GTAL)		24.02	20.24	22.23	17.59	23.49
	Verizon South Inc. (Kentucky - COKY)		30.95	20.60	9.55	5.97	6.62
	Verizon South Inc. (Kentucky - GTKY)		27.21	25.07	24.03	22.34	20.57
	GTE South Inc. (South Carolina - GTSC)					30.62	24.06
	GTE South Inc. (S. Carolina - COSC)					26.14	25.09
32	Verizon South Inc. (Virginia - COVA)	39.94	40.69	40.85	34.74	35.19	33.65
33	Verizon South Inc. (Virginia - GTVA)	7.23	9.53	6.62	9.94	20.56	23.76
34	GTE Southwest Inc. (Texas - COTX)	12.12	11.90	12.17	17.13	14.96	18.10
35	GTE Southwest Inc. (Texas - GTTX)	20.56	24.35	21.65	21.42	16.43	14.81
36	Micronesian Telecomms. Corp. (N. Mariana Islands - GTMC)	32.75	21.83	23.58	29.24	34.45	21.17
	GTE Midwest Inc. (Missouri - COMO + COCM + COEM = COMT)		20.33	17.06	15.29	12.56	12.39
	GTE Midwest Inc. (Missouri - GTMO)		23.92	19.15	11.82	16.08	17.88
	GTE Systems of The South (Alabama - COAL)		15.77	14.93	10.88	7.97	15.31

At the same time, the rural LECs that are members of the National Exchange Carrier Association Interstate Access Charge pools earned 11.94% in 1997, 12.59% in 1998, 11.81% in 1999-2000, and 12.70% in 2001-02.[58] Those earnings levels are virtually identical to the fair rate of return prescribed by the FCC. As pointed out by former Commissioner Diaz Dennis, the Supreme Court has held that the "return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks."[59] It stands to reason that, if the FCC permits the BOCs to achieve earnings well in excess of a fair rate of return earned by other LECs, the Commission can also subject the BOCs to greater risks than it does for other LECs. Therefore, Americatel submits that, to the extent that the BOCs claim to face higher business risks than do rural LECs, from competition and their obligations to serve customers throughout their service territories,[60] including the risk that they might not be able to recover all of their investments, the BOCs' higher rates of return have amply compensated them for this risk.[61] Accordingly, there is no reason for the BOCs' depreciation rates to be increased substantially or any alleged reserve deficiency to be amortized because of competition.

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[58] FCC, *Rate of Return Reports – 1997* (May 1998); FCC, *Rate of Return Reports – 1998* (May 1999); FCC, *Rate of Return Reports – 1999-2000* (May and October 2001); and FCC, *Interstate Rate of Return Summary – Years 1997 through 2002* (May 2003).

[59] *Bluefield Water Works & Improvement Co. v. Public Service Comm'n of West Virginia*, 262 U.S. 679, 692-93 (1923). Moreover, a utility has constitutional protection only against a rate-of-return prescription that is not confiscatory. *Duquesne Light Co*., 488 U.S. at 308, *citing FPC v. Texaco, Inc.,* 417 U.S. 380, 391-92 (1974).

[60] *E.g.,* Comments of BellSouth, at 12-13.

[61] Moreover, the BOCs have generally discontinued their compliance with Statement of Financial Accounting Standards No. 71 ("SFAS 71") that requires regulated entities to keep their investments on their books for financial reporting purposes so long as they believe regulators will grant them cost recovery. By discontinuing the use of SFAS 71, the BOCs also wrote down the amount of their investments in their reports to shareowners and the Securities and Exchange Commission ("SEC") to reflect the likelihood that, because of the advent of competition and

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V. Verizon's Proposed Virginia Legislation Demonstrates the Fallacious Nature of the BOCs' Arguments on the Highly Competitive State of the Local Market

Communications Daily recently reported that Verizon was in the process of drafting legislation for introduction in the Virginia General Assembly that would, *inter alia*, permit "basic dial-tone rates" to rise 10% annually. This clearly demonstrates that the promise of competition and lower prices inherent in the Telecommunications Act of 1996 ("96 Act") simply has not yet arrived and provides the Commission with strong evidence that the TELRIC rules should not be weakened to make it harder for rivals to compete with the BOCs.

A. Neither Congress nor the President Intended that the 96 Act Would Result in Higher Prices for Local Service

No one in Congress who voted for the 96 Act would have supported the law if she or he had understood that the BOCs would be seeking to raise basic local rates in 2004—almost eight years to the date after President Clinton signed the paradigm-shifting bill into law. Rather, the Members' expectation likely was that local rates would be lower today than they were in 1996. Likewise, it seems improbable that President Clinton would have approved the bill had he expected that a BOC would be seeking permission to raise basic local rates by 10% per year in a period of little, if any, inflation.

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changes in the regulatory scheme, the BOCs would never be permitted by regulators to recover all of their prior investments. *See, e.g.,* 1996 Annual Report of BellSouth Telecommunications, Inc. (SEC Form 10-K) at 10. BellSouth wrote down its investments by approximately $2,715 billion to account for its discontinuance of SFAS 71. *Id.*, at 15. Since the BOCs' investors have already discounted the possibility that the BOCs would, indeed, recover all of their investments in network plant, if the Commission were now to permit the BOCs to recover those investments

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Indeed, the legislative history of the 96 Act clearly demonstrates that Congress intended that competition would drive all rates lower. The House Report to H.R. 1555 (the so-called Telecommunications Act of 1995, which was a predecessor bill to that which became the 96 Act) stated that the purpose of the landmark federal legislation was "to promote competition and reduce regulation in order to secure lower prices and higher quality services for American telecommunications consumers."[62] The House of Representatives' report did not suggest that Congress expected prices to fall for every service except for basic residential and small business service. Indeed, it is very unlikely that the BOCs' legion of lobbyists informed Members of Congress and their staffs that, were Congress to pass telecommunications reform legislation, they should expect that their constituents' local phone bills would increase over time, rather than drop.

Another section of the House Report described the Members' expectations as follows:

> For decades, U.S. telecommunications policy has relied on heavily regulated monopolies to provide communications services to businesses and consumers. Advances in telecommunications have greatly benefited consumers and American businesses. Technological advances would be more rapid and services would be more widely available and at lower prices if telecommunications markets were competitive rather than regulated monopolies. Consequently, the Communications Act of 1995 opens all communications services to competition. <u>The result will be lower prices to consumers and businesses,</u> greater choice of

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> through accelerated depreciation expenses and in the form of higher UNE rates, the BOCs and their shareowners would receive a financial windfall.

[62] H.R REP. 104-204, pt. 1, at 47.

> services, more innovation, a competitive edge for American businesses, and less regulation. Indeed, the enormous benefits to American businesses and consumers from lifting the shackles of monopoly regulation will almost certainly earn the Communications Act of 1995 the distinction of being the most deregulatory bill in history.[63]

B. Because Competition Drives Prices Lower, Higher Prices for Local Service Demonstrates a Lack of Competition in that Market

At this point in the debate, the BOCs would likely retort in loud unison: "But local rates are priced below cost, and we need to raise our prices to recover all of our costs." Even if that assertion were true, in a competitive market, there is no guarantee that a service provider will necessarily recover its costs or that consumers will agree to pay higher prices to ensure that their suppliers can make an adequate profit. For example, Deutsche Telekom invested heavily (approximately $40 billion) in VoiceStream Wireless (now T-Mobile USA) and, partially as a result thereof, has been losing money on a grand scale. The Internet version of the *Manchester Guardian* (U.K.) reported in March 2003 that Deutsche Telekom reported a net loss of 24.6 billion Euros for 2002, which was the largest single-year loss in European corporate history.[64]

Despite these losses from its parent company, T-Mobile has been a very aggressive price cutter and not just in traditional voice services. For example, during 2003, T-Mobile offered consumers unlimited data service for laptop computers for only $29.95 per

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63 *Id*., at 47-48 (emphasis added).

64 "Deutsche Telekom Reports Record Losses," *Guardian Unlimited*, March 10, 2003, *available at* http://www.guardian.co.uk/mobile/article/0,2763,911344,00.html (visited January 8, 2004).

month, before taxes and fees, according to an article by Andrew Seybold.[65] Mr. Seybold reported that other wireless carriers were trying to hold the line at a $80 per-month rate for unlimited wireless data and attempting to persuade customers that the carriers' higher transport rates and wider coverage was worth the added price. The market will determine how successful they will be. In any event, it is unlikely that the wireless industry will be seeking legislation to prevent price drops.

Competition drives prices lower than they would be without such competition. Competition in long distance services has driven down toll rates. Competition in wireless services has driven down mobile phone rates. On the other hand, the BOCs have maintained or even raised their rates for local service. One must conclude that, given the failure of local rates to fall since passage of the 96 Act and the desire of some BOCs to raise local rates even higher, there is very probative evidence that local markets simply are not competitive.

The clear intent of Congress in passing the 96 Act, which opened local service to competition and established a pathway for the BOCs to reenter the interLATA market, was that competition should be judged from the consumer's perspective. From a consumer's perspective, the number of competitive choices for local service is immaterial if the competitors are not strong enough to force local rates lower—at least in real terms.

The reentry of the BOCs into the long distance market has created downward pressure on long distance rates—at least for higher volume users. For example, Qwest offers its residential customers a five-cent per-minute domestic long distance rate that, under certain

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65 Andrew M. Seybold, "Breaking the Price Barrier," *Convergence Plus*, August 5, 2003, *available at* http://www.convergenceplus.com/aug03%20wireless%2001.html (visited January 8, 2004).

circumstances, is capped at $20 per month, regardless of the number of domestic calls made by the consumer.[66] If viewed only from the long distance monthly bill perspective, one could conclude that BOC reentry into long distance has generated some consumer benefits.

However, a full analysis of the consumer benefit issue cannot stop at long distance bills alone. Many of the BOCs' special long distance rates plans, including Qwest's $20 per month cap plan, are conditioned on the consumer's purchase of a bundle of services.[67] Many consumers might well be better off financially with a "package of services" from multiple carriers. For example, the minimum-cost local service bundle that qualifies a Qwest Colorado customer for the $20 per month rate cap is Qwest's $25.99 per month Qwest Choice™ Home package.[68] Excluding fees and taxes, a Colorado consumer selecting this package of services would pay Qwest $45.99 per month, assuming that the consumer made 400 minutes of domestic long distance calls per month.[69] From a consumer's perspective, one must actually make more than 400 minutes of domestic long distance calls (about six hours, 40 minutes) before the $20 cap provides a benefit. The same consumer might well be better off by purchasing Qwest's basic residential line without bells, whistles and gongs, for $14.96 per month, before taxes and fees,[70] and using dial-around long distance services from another carrier.

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66 http://www.qwest.com/pcat/for_home/product/1,1354,2035_1_13,00.html (visited January 9, 2004).

67 *Id.* Qwest will not cap total charges for its five-cent per-minute domestic long distance rate plan at $20 unless the consumer also purchases a package of bundled local services.

68 http://www.qwest.com/residential/products/packages/index.html (visited January 9, 2004).

69 At 5¢ per minute, a customer reaches the $20 cap when she or he makes 400 minutes of domestic long distance calls in a single month.

70 http://www.qwest.com/pcat/for_home/product/1,1354,73_1_7,00.html (visited January 9, 2004).

There is certainly nothing wrong with bundled services. Indeed, service packages can provide some consumers with significant savings. However, it is still very unlikely that Congress intended that only consumers who purchased bundled service packages would benefit from competition or that a Colorado consumer would need to purchase a package of local services at a price that is more than 73% higher than the basic residential line service in order to receive unlimited domestic long distance service for $20 per month.

If the FCC grants the BOCs a new TELRIC plan that forces UNE prices upward, there will be less local competition. Fewer residential and small business consumers will pay lower rates. Indeed, consumers are likely to see the BOCs attempt to raise local prices higher. The FCC must not permit the BOCs to raise local rates by increasing UNE rates that would, in turn, reduce the ability of competitors to challenge the BOCs' local markets.

VI. CONCLUSION

For the reasons set forth above, the Commission should not amend its TELRIC rules.

Respectfully submitted,
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January 30, 2004

CERTIFICATE OF SERVICE

I, Lila A. Myers, do hereby certify that the foregoing **REPLY COMMENTS OF AMERICATEL CORPORATION** was served on this 30th day of January, 2004 upon the following by U.S. mail or e-mail (where designated by *):

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